No. 15821 ✓ See: Vol. 3060

United States Court of Appeals

For the Ninth Circuit

JOHN R. HANSEN and SHIRLEY G. HANSEN, *Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR PETITIONERS

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United States Court of Appeals
For the Ninth Circuit

John R. Hansen and Shirley G. Hansen, *Petitioners,* vs. Commissioner of Internal Revenue, *Respondent.*	No. 15821

Petition to Review a Decision of the Tax Court of the United States

BRIEF FOR PETITIONERS

STATEMENT OF JURISDICTION

This is a petition to review a decision of the Tax Court of the United States. The United States Court of Appeals has exclusive jurisdiction, by Section 7482 (a) of the Internal Revenue Code.

Venue for review by the United States Court of Appeals for the Ninth Circuit, is based upon Section 7482 (b) (1) of the Internal Revenue Code. The returns of Tax in respect to which the controversy arises, were made to the office of the Internal Revenue Service in Tacoma, Washington, within the Ninth Circuit (R. 5).

Jurisdiction of the Tax Court of the United States was based on Section 6213 (a) of the Internal Revenue Code. Timely petition for redetermination of the deficiency was filed with the Tax Court (R. 6).

STATEMENT OF THE CASE

Petitioners are John R. Hansen and Shirley G. Hansen, husband and wife. Mr. Hansen was doing business as an automobile dealer in the years at issue. Respondent determined that there were deficiencies in income tax for the petitioners for the calendar years 1951, 1952 and 1953, and penalties for the same years. After exhaustion of the procedure for administrative review, Notice of Deficiency was mailed on January 27, 1956. Petitioners filed Petition for Redetermination of Deficiency with the Tax Court of the United States, on April 26, 1956. Amended Petition was filed by stipulation.

Petitioners disputed all alleged deficiencies resulting from the allocation to income of a contingent liability reserve withheld from Petitioners by General Motors Acceptance Corporation. Petitioners further disputed penalties imposed for failure to file declaration of estimated tax, under section 294(d)(1)(A) of the Internal Revenue Code (1939), and for substantial underestimation of declaration of estimated tax, under section 294(d)(2) of the Internal Revenue Code (1939).

The Tax Court of the United States entered decision in favor of the Commissioner of Internal Revenue, respondent herein, on August 1, 1957. Petition for Review by the United States Court of Appeals for the Ninth Circuit, was filed by registered mail with the Tax Court, pursuant to Rule 29, on October 31, 1957.

The taxes and penalties in controversy are:

Taxable Year	Income Tax	Penalties, I.R.C. of 1939 Section 294(d)(1)(A)	Section 294(d)(2)
1951	$1,092.66	$847.66	$565.10
1952	686.40	563.51	375.67
1953	3,221.46	532.64	355.10

Upon this appeal petitioners are not disputing the penalties imposed for failure to file declarations of estimated tax, under section 294(d)(1)(A) I. R. C. (1939); excepting insofar as such penalties were based upon the erroneous allocation of contingent liability reserve to income.

Petitioners made payments to respondent in lieu of bond pending this appeal, of $4,750.00 on January 15, 1958, and of $4,840.39 on January 23, 1958, without waiver of the questions involved in this appeal.

QUESTIONS INVOLVED

(1) Did finance fees withheld by General Motors Acceptance Corporation in a contingent liability reserve, accrue as income to auto-dealer petitioners in the year when the reserves were created by G.M.A.C., or alternatively, in the year when released to petitioners, if ever released at all? This is the main issue.

(2) Does petitioners' failure to file declarations of estimated tax in 1951, 1952 and 1953, incur the distinct penalty for substantial underestimation of declaration of estimated tax, under I. R. C. (1939) Sec. 294(d)(2); where no estimated returns at all were filed and where the explicit pen-

alty for failure to file was imposed under I. R. C. (1939) Sec. 294(d)(1)(A)?

STATEMENT OF THE FACTS

1. Petitioners are husband and wife, residing in a community-property state, where the husband is a Buick dealer engaged in the business of selling automobiles at retail (Alleged, R. 10; Admitted, R. 26).

2. Petitioners sell new autos upon conditional sales contracts (Admitted, R. 26).

3. All of petitioners' sales on credit in the tax years at issue were made upon the same G.M.A.C. form of conditional sales contract, Joint Exhibit 5-E, and all were financed by General Motors Acceptance Corporation (Stipulated, R. 6).

4. The conditional sales contracts were payable by the retail purchaser at the office of General Motors Acceptance Corporation (Joint Exhibit 5-E, (8), at R. 39).

5. Petitioners in fact held none of the conditional sales contracts for financing by petitioners, and financed none of them through any finance company other than G.M.A.C. (Stipulated, R. 6; R. 29).

6. The course of dealing between petitioners and G.M.A.C. required that a contingent liability reserve, called "Dealer's Reserve," be withheld by G.M.A.C. out of the finance charges (R. 30, 31, 35, 36).

7. The pattern of petitioners' financing of credit sales was a single transaction: The retail purchaser signed the conditional sales contract on the same form;

petitioners assigned the contract to G.M.A.C. by the same form for assignment on the face of the contract, and delivered it to G.M.A.C. in return for money (R. 6, 35; Joint Exhibit 5-E at R. 39).

8. The amounts of the contingent liability reserve was set at five per cent of the total amount of conditional sales contracts outstanding with G.M.A.C. for petitioners' customers (R. 31).

9. The purpose of the reserve was to protect G.M.A.C. from losses. Losses from prepayment by auto purchasers and losses from abnormal depreciation before repossessions were chargeable to the reserve (R. 31).

10. The reserve was withheld and controlled completely by G.M.A.C. (R. 32).

11. Petitioners could not draw upon the contingent liability reserve at will; could not borrow against it; and had no right to any of the reserve until release by G.M.A.C. (R. 32, 38).

12. Release of any reserve was contingent upon there being in the reserve an excess over five per cent of outstanding contracts (R. 31).

13. Loss chargeable to contingent liability reserve did occur, due to prepayments and due to abnormal depreciations before repossession (R. 31).

14. Petitioners withdrew funds released to them when they could get them, and took all they could get (R. 33).

15. All payments actually received by petitioners from G.M.A.C., including funds released from contin-

gent liability reserve, were reported as income in the years in which received (R. 33, 36, 37).

16. Losses already charged by G.M.A.C. against the contingent liability reserve were not written off by petitioners as bad debts. Petitioners' bad debts account had nothing to do with the sale of autos on credit (R. 32, 37).

17. Petitioners' accounts followed a regular and consistent theory of accounting in 1951, 1952 and 1953, excepting only that all contingent liability reserves created by G.M.A.C. in 1952 were picked up as income in 1952 (R. 35).

18. Petitioners' accounting was upon the accrual basis (R. 36).

SPECIFICATION OF ERRORS

(1) The Tax Court erred in holding that finance fees withheld by General Motors Acceptance Corporation in a contingent liability reserve, accrued as income to auto-dealer petitioners in the year in which the reserves were created by G.M.A.C., rather than in the year in which released to petitioners, if ever released at all (R. 65).

(2) The Tax Court erred in sustaining penalties imposed for substantial underestimation of declaration of estimated tax, under I. R. C. (1939) Sec. 294(d)(2), where no estimated returns at all were filed and where the explicit penalties for failures to file were imposed under I. R. C. (1939) Sec. 294 (d)(1)(A) (R. 67, 68).

(3) The Tax Court erred in sustaining penalties where

the penalties were based upon amounts erroneously held to be income; both as to penalties imposed for failure to file declarations of estimated tax, under I. R. C. (1939) Sec. 294(d)(1)(A), and as to penalties imposed for substantial underestimation, under I. R. C. (1939) Sec. 294(d)(2) (R. 70).

(4) The foregoing errors render erroneous the entry of decision wherein the Tax Court ordered and decided that there are deficiencies for the taxable years of 1951, 1952 and 1953, totalling $8,240.20 (R. 70).

PETITIONERS' ARGUMENT

I.

FINANCE FEES WITHHELD IN CONTINGENT LIABILITY RESERVE BY G.M.A.C. ACCRUED AS INCOME TO AUTO-DEALER PETITIONERS IN THE YEAR WHEN RELEASED TO PETITIONERS, AND NOT IN THE YEAR WHEN CREATED AS RESERVE BY G.M.A.C.

A. NONE OF THE FUNDS IN ISSUE WERE RELEASED TO PETITIONERS IN THE TAX YEARS INVOLVED

The only funds in issue here are those withheld by G.M.A.C. in its contingent liability reserve, and not released to petitioners in the tax years. Where there was an excess of reserve over 5 per cent of outstanding contracts financed for petitioners, the excess was released by G.M.A.C. annually. Petitioners withdrew funds released to them when they could get them, and took all they could get. Petitioners have declared every such payment received.

B. EACH SALE OF AN AUTO ON CREDIT WAS A SINGLE THREE-PARTY TRANSACTION, TO WHICH G.M.A.C. WAS A NECESSARY PARTY

In substance the sale of an auto on credit was and had to be a single three-party transaction. Petitioners sold an auto, for trade-in and cash. G.M.A.C. sold the use of its money, for a finance charge. The purchaser bought both—the auto from the dealer, and the credit from the finance company. The finance charge was G.M.A.C.'s price for the use of its money, and was gross income to G.M.A.C., not to petitioners.

There had to be a finance company in each transaction, because the purchaser was unable to pay cash for the car. G.M.A.C. was a necessary party to every sale of an auto on credit. The absence of contractual requirement to finance sales through G.M.A.C. is immaterial, where practical business necessity caused every credit sale to be so financed.

Petitioners used the same finance company to finance every credit sale during the three tax years in issue, without exception. They used the same conditional sales contract and assignment form. As the United States Court of Appeals, Fourth Circuit, said in *Blaine Johnson v. Commissioner* (1956) 233 F.2d 952, at 957:

> "The pattern of each sale was a single transaction from the time the trailer was sold through the time the note was discounted by the particular finance company on whose forms it was executed."

The Sixth Circuit has said:

> "And without regard to whether the result is imposition or relief from taxation, the courts have recognized that where the essential nature of a

> transaction is the acquisition of property, it will be viewed as a whole, and closely related steps will not be separated either at the instance of the taxpayer or the taxing authority." *Commissioner v. Ashland Oil & Refining Co.*, 99 F.2d 588, 591, cert. denied 4-17-39.

In *Helvering v. New Haven & Shore Line Ry. Co., Inc.*, 121 F.2d 985, 988, cert. denied 2-9-42, the Second Circuit said:

> "As for the effort of the Commissioner to atomize the plan, as it were, *i.e.*, to separate it into its several steps and treat the last as though it stood alone, it has been repeatedly repudiated."

C. PETITIONERS HAD NO ACTUAL RECEIPT OF THE FUNDS IN ISSUE, AS INCOME

Petitioners had no actual receipt of the funds in issue, as income. Each conditional sales contract provided for the time payments to be made at the office of G.M.A.C. No time payments were made to petitioners. Each contract was assigned by petitioners to G.M.A.C. upon execution. The consideration paid to petitioners by G.M.A.C. was taken up and declared by petitioners as income, and is not in issue.

D. PETITIONERS HAD NO CONSTRUCTIVE RECEIPT OF THE FUNDS IN ISSUE, AS INCOME

Petitioners had no constructive receipt of the funds in issue, as income. Regulation 118, §39.42-2, sets forth the doctrine of constructive receipt. It provides that income may be taxed prior to the year of actual receipt although not then actually reduced to possession, if: (1) it is credited to the account of or set apart

for the taxpayer, and (2) it may be drawn upon by the taxpayer at any time.

> "To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition * * * " Reg. 118, §39.42-2.

The plain fact is that the reserve withheld by G.M.A.C. could not be "drawn upon by petitioners at any time." There could be no payment to petitioners at all unless the reserve exceeded 5 per cent of total outstanding contracts financed for petitioners; and then payment was limited to the excess, without invasion of the 5 per cent reserved which the Commissioner has allocated to income.

There were substantial, concrete, restrictive conditions precedent. Any payment to petitioners was contingent upon an excess, which could result only if G.M.A.C. had favorable experience in collections upon the contracts from customers of petitioners. Favorable experience was uncertain, because losses from prepayments by auto purchasers were chargeable to the reserve, as were losses for abnormal depreciation before repossession. The testimony establishes that there always were such losses. Because of losses to be charged to the reserve, the ultimate receipts from it by petitioners were not determinable at the dates of creation of reserve.

G.M.A.C. retained control of the contingent liability

reserve. Petitioners had no enforceable right to the funds in issue. Neither bankruptcy nor starvation would have given petitioners a legal right to reach the reserve. It was a true reserve, with specific conditions precedent and definite contingencies, in the control of a party dealing at arm's length with petitioners.

E. THE U. S. COURT OF APPEALS FOR THE SIXTH CIRCUIT DECIDED A SIMILAR ISSUE IN FAVOR OF A TAXPAYER, IN 1932

In the case of *Commissioner v. Cleveland Trinity Paving Co.* (1932) 62 F.2d 85, the Court of Appeals for the Sixth Circuit reached the same result, in principle. It held that, under a paving contract, percentages retained to guarantee maintenance of pavement were taxable as income to the contractor in the years when the money was paid, rather than in the years when the contracts were completed except as to maintenance. The court noted "the further principle that the fact that the taxpayer kept its books in most respects upon the accrual basis does not require it to accrue that which is but contingently earned." *Commissioner v. Cleveland Trinity Paving Co.* (1932) 62 F.2d 85. The Commissioner did not appeal.

F. THE U. S. COURT OF APPEALS FOR THE THIRD CIRCUIT DECIDED THE PRESENT ISSUE IN FAVOR OF A TAXPAYER, IN 1944

The United States Court of Appeals for the Third Circuit decided the present issue in 1944, in *Keasbey & Mattison Co. v. United States*, 141 F.2d 163. The taxpayer was a manufacturer of asbestos products who

arranged with a finance company to discount notes given by purchasers to retailers of its products. Under its contract with the finance company the taxpayer guaranteed part of the notes. Part of the discount was to be retained by the finance company in a reserve account analogous to G.M.A.C.'s reserve, to cover the guaranty. Circuit Judges Biggs, Jones and Goodrich unanimously held that the amount of the reserve was not income to the taxpayer so long as the right to any of it was uncertain. The *Keasbey & Mattison* case involves the same principles as the *Hansen* case, and is directly in point. The United States did not appeal.

G. THE U. S. COURT OF APPEALS FOR THE FOURTH CIRCUIT DECIDED THE PRESENT ISSUE IN FAVOR OF A TAXPAYER, IN 1956

The United States Court of Appeals for the Fourth Circuit decided the present issue in *Blaine Johnson v. Commissioner* (1956) 233 F.2d 952. The taxpayers were dealers in trailers, who financed credit sales by endorsing purchasers' promissory notes over to banks and to a finance company. A variable reserve was withheld from the taxpayers by the bank or finance company.

The court held that the reserves withheld were not taxable income to the taxpayer in the years in which credited as reserves, but rather in the years in which they became payable to taxpayers.

The court said:

> "The general principles which must control our decision have been authoritatively stated by the Supreme Court. It is 'the right to receive and not

> the actual receipt' of an amount which determines its accruability. 'When the right to receive an amount becomes fixed, the right accrues.' *Spring City Foundry Co. v. Commissioner,* 292 U.S. 182, 184, 185, 54 S.Ct. 644, 645, 78 L.Ed. 1200. Until the right to an amount becomes accruable through fixation of the right to receive, the taxpayer is under no obligation to return it as income. Otherwise he would be required to pay a tax on income which he might never have a right to receive. *North American Oil Consolidated v. Burnet,* 286 U.S. 417; 423-424, 52 S.Ct. 613, 76 L.Ed. 1197." *Blaine Johnson v. Commissioner* (1956) 233 F.2d 952, at 956.

The Fourth Circuit reaffirmed the principles stated in the *Blaine Johnson* case, *supra,* in *Long Poultry Farms, Inc. v. Commissioner* (1957) 249 F.2d 726. A patronage refund credit alloted to the taxpayer by an agricultural cooperative association had been retained by the association as a reserve. The credit in reserve was held not includible as income to the taxpayer because it was "a contingent credit."

H. THE U. S. COURT OF APPEALS FOR THE FIFTH CIRCUIT HAS DECIDED THE PRESENT ISSUE IN FAVOR OF TAXPAYERS IN TWO CASES, IN 1958

The Tax Court holding again was reversed, in *Texas Trailercoach, Inc. v. Commissioner* (1958) — F.2d —, 1 A.F.T.R.2d 58-533, reversing 27 T.C. 575. The taxpayer was a dealer in trailers from whom amounts had been withheld in dealers reserve, by a finance company. The Fifth Circuit held that the amounts in reserve were not income to the dealer until there was a fixed

right to receive them, under the terms of the agreement between dealer and finance company.

The court pointed out in the *Texas Trailercoach* case that tax incidence should reflect the realities of a business transaction, *Ibid.,* 1 A.F.T.R.2d 58-533, -534; that the sale on credit was "one transaction—a three-cornered agreement with interrelated obligations of dealer, purchaser, and finance company." *Ibid.,* 1 A.F.T.R.2d 58-533, -535; and that "from a lay or purely practical point of view, the five per cent did not become fixed or ascertainable and therefore accrue in the taxable year in question." *Ibid.,* 1 A.F.T.R.2d 58-533, -535. The basic principles controlling accrual were reviewed in part IV of the decision.

Circuit Judge Wisdom said:

> "The real trouble in this case is that the taxpayer is asked to pay a tax on money he did not in fact receive and had no right to receive during the taxable year in question. He may never receive it, but he is asked to deplete his cash in order to pay it. If compelled to pay, the more business he does —the worse off his cash position will be. But, if a more realistic view is taken, the Government will not be deprived of any tax, because when the contingent credit materializes as a fixed, ascertainable claim or if payments are received from the reserve account, the taxpayer must then include the fixed claim or payments in his taxable income." *Texas Trailercoach, Inc. v. Commissioner* (5 Cir. 1958) — F.2d —, 1 A.F.T.R.2d 58-533, 541.

Petitioners submit that the *Texas Trailercoach* decision, *supra,* fits the present case in that the sale on credit was one three-cornered transaction, the reserve

to be received was not fixed or ascertainable in the tax year, and in that there was no actual receipt or right to receive in the tax year in question.

West Pontiac, Inc. v. Commissioner (5 Cir. 1958) — F.2d —, 1 A.F.T.R.2d 58-451, reversing 25 T.C. 749, was a dealers reserve case in which the taxpayer was a General Motors dealer, financing with G.M.A.C. After the *Texas Trailercoach* decision, *supra,* West Pontiac moved for judgment. The Commissioner by letter appeared to the court to agree that the issue was essentially the same as in *Texas Trailercoach, supra.* Judgment was entered in favor of the taxpayer, without briefing and oral argument.

District Courts have held that dealers' reserve withheld did not accrue as income, in *Massey Motors, Inc. v. United States* (S.D. Fla. 1957), 156 F.Supp. 516; *Hines Pontiac v. United States* (N.D. Texas 1957), — F.Supp. —, 1 A.F.T.R.2d 58-734, and in *Modern Olds, Inc. v. United States* (N.D. Texas 1957), — F. Supp. —, 1 A.F.T.R.2d 58-732.

I. APPELLATE AUTHORITY SHOULD BE UPHELD

> "The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court * * *; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari * * *." I.R.C. (1954) sec. 7482 (a).

The Courts of Appeals have in each instance upheld the taxpayer upon the dealer's reserve issue. *Keasbey & Mattison Co. v. United States* (3 Cir. 1944) 141 F.2d

163; *Blaine Johnson v. Commissioner* (4 Cir. 1956) 233 F.2d 952; *Texas Trailercoach, Inc. v. Commissioner* (5 Cir. 1958), — F.2d —, 1 A.F.T.R.2d 58-533; *West Pontiac, Inc., v. Commissioner* (5 Cir. 1958) — F.2d —, 1A.F.T.R.2d 58-451.

The Commissioner has declined to follow the rule of the Courts of Appeals, Rev. Rul. 57-2, Int. Rev. Bulletin 1957-1, P-H 1957 par. 76,301. The Tax Court has declined to follow the rule of the Courts of Appeals. *Blaine Johnson,* 25 T.C. 123; *Albert M. Brodsky,* 27 T.C. 216; *West Pontiac, Inc.,* 27 T.C. 749; *Texas Trailercoach, Inc. v. Commissioner,* 27 T.C. 575; *Burl P. Glover,* par. 57,045 P-H Memo T.C.; *J. H. Schaeffer, Jr., et al.,* par. 57,068 P-H Memo T.C.; *John R. Hansen, et al.,* par. 57,113 P-H Memo T.C.

This situation works injustice, because only the taxpayer who can pay the expense of appeal can prevail, and he only at considerable expense. As each additional Circuit rules against the Commissioner, his position should become more awkward. Petitioners submit that the appellate authority should be upheld.

II.

FAILURE TO FILE DECLARATIONS OF ESTIMATED TAX IN 1951, 1952 AND 1953, DOES NOT INCUR THE DISTINCT PENALTY FOR SUBSTANTIAL UNDERESTIMATION OF DECLARATIONS

A. FAILURE TO FILE AN ESTIMATION IS NOT UNDERESTIMATION

Congress imposed only a single civil penalty for failure to file declarations without reasonable cause. There

are two separate and distinct penalties in the Code, one of 6 per cent for substantial underestimate, and the other of 10 per cent for failure to estimate at all. If Congress intended a 16 per cent penalty for failure to file, Congress would have made it 16 per cent.

I.R.C. (1939) sec. 294 (d) provides:

> "(1) Failure to File Declaration or Pay Installment of Estimated Tax.—(A) Failure to file declaration.—In the case of a failure to make and file a declaration of estimated tax within the time prescribed, unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect, there shall be added to the tax 5 per centum of each installment due but unpaid, and in addition, with respect to each such installment due but unpaid, 1 per centum of the unpaid amount thereof for each month (except the first) or fraction thereof during which such amount remains unpaid. In no event shall the aggregate addition to the tax under this subparagraph with respect to any installment due but unpaid, exceed 10 per centum of the unpaid portion of such installment.* * *."
>
> "(2) Substantial Underestimate of Estimated Tax.— If 80 per centum of the tax * * * exceeds the estimated tax * * * there shall be added to the tax an amount equal to such excess, or equal to 6 per centum of the amount by which such tax so determined exceeds the estimated tax so increased, whichever is the lesser * * *."

The legislative intent to impose only a single penalty for failure to file was demonstrated in the Internal Revenue Code of 1954. The separate penalty for failure to file declarations of estimated tax was removed, I.R.C.

(1954) sec. 6651 (c); and a single penalty of 6 per cent per annum was imposed for failure to pay estimated tax, whether declaration was filed or not. I.R.C. (1954) sec. 6654.

B. FIVE DISTRICT COURTS HAVE DETERMINED THIS ISSUE IN FAVOR OF TAXPAYERS

The U.S. District Court for the Northern District of Georgia decided this point in 1954 in the case of *United States v. Ridley,* 120 F.Supp. 530, at page 538:

> "The addition of 10% of the tax for failure to file the declaration or to pay the installment of the estimated tax is proper to be added in the appropriate years. However, the addition of 6% for substantial underestimate of estimated tax is improper for the very obvious reason that the tax was not underestimated, indeed, the taxpayer filed no declaration of estimated tax at all and suffers the greater sanction of 10% addition to the tax for the failure, and the failure to pay the tax.
>
> "The argument of the government that the failure to file the declaration of estimated tax is in effect a declaration of no tax, thus subjecting the taxpayer to this penalty, is rejected as contrary to a proper construction of the statutes."

The *Ridley* decision has not been appealed. It was followed in *Powell v. Granquist* (D.C. Oregon 1956), 146 F.Supp. 308.

Owen v. United States (D.C. Nebr. 1955), 134 F. Supp. 31, supports petitioners' position. Taxpayer was held not subject to penalty for substantial underestimate, although he was subject to penalty for failure to file. Appeal was dismissed on stipulation of parties. *United States v. Owen* (8 Cir. 1956) 232 F.2d 894.

In *Stenzel v. United States* (D.C. N.D. Cal. 1957), 150 F.Supp. 364, the sole issue was whether the government could collect the 6% penalty for underestimation in addition to the 10% penalty for failure to file. In holding for the taxpayer, District Judge Harris said:

> "There is nothing in the history of the Revenue Act of 1943 which shows that in rewriting Section 294 (d) (2), Congress intended that, in the event of the failure to file the required declaration the amount of the estimated tax would be zero. The construction contended for by the government is inconsistent with the plain congressional intention. It attempts, inferentially, to dignify a Bureau regulation giving it the same force and effect as congressional enactment. The cumulative penalties sought to be imposed are in conflict with any fair, reasonable and just statutory construction." *Stenzel v. United States* (D.C. N.D. California 1957), 150 F.Supp. 364, at 365.

In *Jones v. Wood* (D.C. Ariz. 1957), 151 F.Supp. 678, 680, Chief Judge Ling said:

> "The penalty for substantial underestimation of tax cannot lawfully be imposed unless an estimate of tax has been filed.* * * The imposition is improper for the very obvious reason that the tax was not underestimated. Indeed there was no estimate filed at all."

Farrow v. United States (D.C. S.D. Cal. 1957), 150 F.Supp. 581, is contra.

As a matter of law, petitioners submit that the penalty for substantial underestimation cannot properly

be imposed for petitioners' failure to file declarations of estimated tax in 1951, 1952 and 1953.

III.

PENALTIES BASED UPON AMOUNTS ERRONEOUSLY HELD TO BE INCOME SHOULD NOT BE SUSTAINED

The Tax Court determined penalties against petitioners in its decision below (R. 70). Each of these penalties was computed as a percentage of an amount held to be income, pursuant to I.R.C. (1939) §§294 (d) (1) (A) and 294 (d) (2). It is clear that insofar as the amounts held to be income were not income, the penalties thereupon were erroneous and should not be sustained.

CONCLUSION

Petitioners submit that the contingent liability reserve withheld from them did not accrue as income unless and until released to them; that penalties for substantial underestimation were not incurred by failure to file declarations of estimate; that penalties based upon amounts erroneously held to be income should not be sustained; and that the foregoing errors render erroneous the decision below wherein the Tax Court determined deficiencies for 1951, 1952 and 1953 totalling $8,240.20.

Wherefore petitioners pray that the decision of the Tax Court be held erroneous and be reversed.

Respectfully submitted,

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APPENDIX

Joint Exhibit 5-E, at page 39 of the record, was stipulated at R. 6.